

TABLE ONE

23.

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24. Again, these are upper bound estimates of the potential losses to Qwest, assuming somewhat unrealistically that every special access circuit within the Qwest region is flipped to UNE rates. As noted previously, the FCC has placed restrictions on which special access circuits are eligible for conversion to UNEs. However, the discussion above highlights the fact that AT&T and MCI are unusually well positioned through their access to local service traffic to convert even their interexchange and wireless service special access circuits to UNE rates. Similarly, relatively few special access circuits are expected to fail the FCC's impairment test as a result of changes being implemented by the *Triennial Review Remand Order*. My understanding is that approximately seven percent of wire centers will see UNE availability disappear as a result of the TRRO.

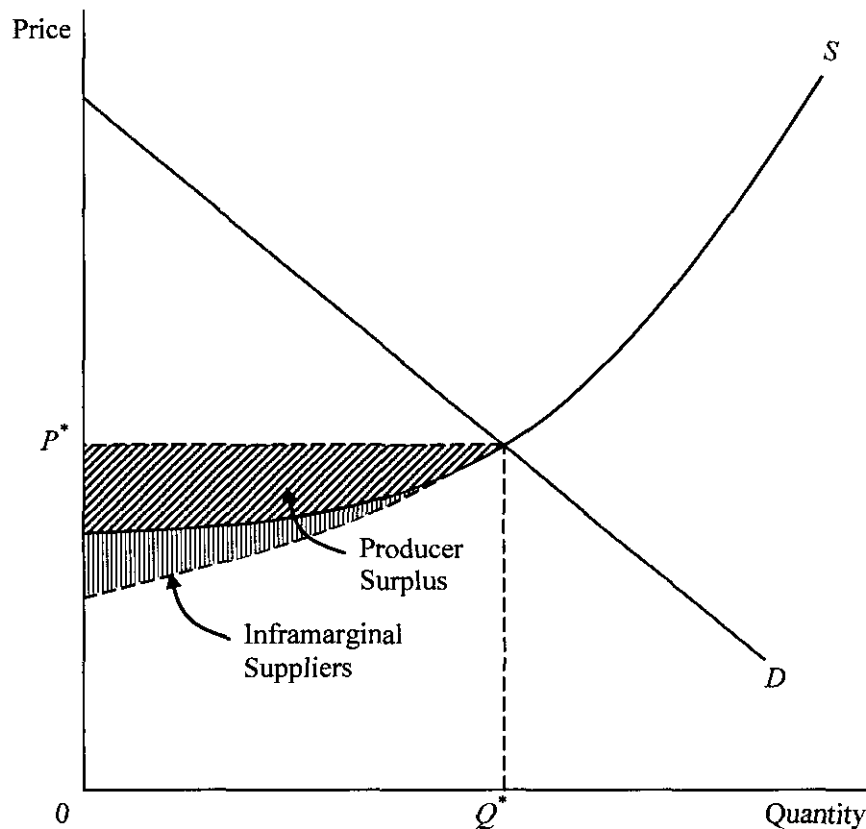
III. IMPLICATIONS OF THE FLIPPING RULES IN LIGHT OF THE PROPOSED MERGERS

A. *The Role of AT&T and MCI*

25. AT&T and MCI are "inframarginal" suppliers of telecommunications services sold to buyers in the long-distance and large-enterprise markets. An inframarginal supplier is a firm whose marginal costs of production are lower than the marginal production costs of the highest-cost (or "marginal") suppliers. Moreover, the inframarginal nature of AT&T and MCI will be enhanced post merger because (1) the size of SBC's and Verizon's regions and (2) competitors will have to buy circuits at special access rates in those regions, while AT&T and

MCI will have access to in-region circuits at the true marginal cost. For illustrative purposes, Figure One below displays a hypothetical market, in which market demand is labeled D and market supply is labeled S . Inframarginal suppliers comprise the portion of the market supply curve to the left of the point of intersection with the market demand curve. The market equilibrium in price and output is determined when the highest-cost firm has marginal costs just equal to the lowest valuation of buyers. In other words, equilibrium price and output, labeled P^* and Q^* in Figure One, is determined by the intersection of supply and demand. Importantly, reductions in the production costs of inframarginal firms cannot affect the equilibrium price in the market, P^* , because that price is determined on the supply side by the highest-cost firm.

FIGURE ONE
INFRAMARGINAL SUPPLY IN A HYPOTHETICAL MARKET



26. The effect of AT&T and MCI flipping circuits will be to lower that portion of the market supply curve determined by the inframarginal suppliers. This is shown in Figure One by a downward shift in the market supply curve from the solid to the dashed line. Since AT&T and MCI are inframarginal suppliers, reductions in their production costs due to circuit flipping do not affect prices in the enterprise market. Therefore, circuit flipping by AT&T and MCI will not result in lower market prices.

27. Conversely, if all firms supplying the long-distance and data markets could flip circuits, then the equilibrium price would be lower. That is, because the marginal costs of every firm is lower, circuit flipping would result in lower prices in the enterprise market because it lowered the marginal costs of marginal as well as inframarginal suppliers. Such a general decline in firms' marginal costs would have the effect of lowering the marginal costs of the highest-cost firm in the market. This would result in lower prices, as firms with relatively high marginal costs would be able to supply buyers whose marginal valuations were below the prior equilibrium price. (This scenario, represented graphically by a downward shift in the market supply curve is not displayed in Figure One.)

28. Circuit flipping will increase producer surplus as the rents accruing to inframarginal suppliers, such as AT&T and MCI, will increase. This is represented in Figure One by an increase in the size of the shaded area. Conversely, there is likely to be little or no increase in consumer surplus, as firms with relatively high marginal costs tend to have relatively few circuits that could be flipped. In this case, the net result when a circuit is flipped in Qwest's region will be a transfer from Qwest to SBC or Verizon without a reduction in prices, from which consumers in the enterprise market would benefit.

29. AT&T and MCI have some history with respect to the effect of exogenous cost reductions on their prices. Since the breakup of AT&T in 1984, the Commission has continually reduced interstate switched access charges.²⁴ In return, as noted by the Commission, “[m]ajor long distance companies have committed to passing through these reductions [in access charges] to consumers.”²⁵ However, the evidence shows that despite the commitments of major long-distance carriers, they did not pass through the reductions in access charges.²⁶ This historical experience over twenty years should give pause to a claim that reductions in wholesale local access costs achieved through flipping circuits would be passed through to consumers.

30. In summary, circuit flipping will redistribute revenues from input suppliers of wholesale access services to inframarginal suppliers in the national, long-distance and enterprise markets. Consumers, however, will see little or no decline in retail prices as a result of flipping. Moreover, given the effect of flipping on the facilitating tacit collusion between the post-merger SBC and Verizon (see Section IV), the likely net effect of circuit flipping will be to increase retail prices over time.

B. The Role of SBC and Verizon

31. By any standard, the two proposed mergers, if approved, will fundamentally change the structure of the U.S. telecommunications industry. SBC and Verizon will be far and away the two largest firms, having a combined market value of almost \$200 billion. Post-merger

²⁴ See, e.g., Paul W. MacAvoy and Michael A. Williams (2002), DEREGULATION OF ENTRY IN LONG-DISTANCE TELECOMMUNICATIONS, Michigan State University, p. 27.

²⁵ Federal Communications Commission News Release, “FCC Reduces Access Charges by \$3.2 Billion; Reductions Total \$6.4 Billion Since 1996 Telecommunications Act,” http://www.fcc.gov/Bureaus/Common_Carrier/News_Releases/2000/nrcc0029.html (May 31, 2000).

²⁶ See, e.g., Paul W. MacAvoy and Michael A. Williams (2002), DEREGULATION OF ENTRY IN LONG-DISTANCE TELECOMMUNICATIONS, Michigan State University, Chapter 2; Clement G. Krouse and Jongsur Park (2003),

SBC and Verizon will be uniquely positioned to use circuit flipping as a strategic tool with which to credibly threaten both each other and potential entrants (see Section IV).

32. In the market for long-distance telecommunications, the post-merger firms will be able to reduce their costs as inframarginal suppliers more than other firms, including both marginal and inframarginal suppliers, since they will be the two largest purchasers of special access services. For the reasons described above, such a cost reduction would not likely affect the prices of long-distance services.

33. Similarly, in markets for out-of-region local telecommunications, the two post-merger firms also will be able to reduce their costs more than other such firms given their special access purchases, again with little or no anticipated effect on prices paid by consumers. Unfortunately, the effect of these cost reductions will be to reduce the firms' incentives to invest in out-of-region local facilities. In markets for in-region local services, the two proposed mergers would facilitate the routing of SBC and Verizon local traffic over the circuits of AT&T and MCI, making these firms' special access circuits especially eligible for flipping.

IV. POTENTIAL HARMS TO COMPETITION

34. This section discusses the likely harm to competition caused by the ability of post-merger SBC and Verizon to flip circuits. The expected harm will be in the form of higher prices to purchasers of telecommunications services, particularly enterprise customers. The harms flow from the enhanced ability of post-merger SBC and Verizon to enforce tacitly collusive outcomes between each other, as well as their enhanced ability to block entry by Qwest

Competition in the Interexchange Telecommunications Market, JOURNAL OF LAW AND ECONOMICS, vol. 46, pp. 85-101.

and other firms into their respective regions. Additional harms to competition will flow from the adverse effects of circuit flipping on the incentives of firms to invest in new facilities, particularly out-of-region facilities for the RBOCs.

A. Threat of Flipping as a Tool to Enforce Collusion and High Prices

i. SBC and Verizon Have an Effective Tool to Facilitate and Sustain Tacit Collusion.

35. In this section, I address whether the ability to flip circuits may facilitate tacit collusion between SBC and Verizon. Tacit collusion occurs when firms act in concert through equilibrium behavior rather than through explicit agreement to reduce competition, which results in supra-competitive prices. As a hypothetical example, suppose it were profitable for firm A to enter firm B's market and compete down the price in that market. Firm A chooses not to enter, however, because of the threat of retaliation – in particular, that firm B would enter and sufficiently compete down price in firm A's market, offsetting the additional profits earned by firm A from entry. By a similar logic, firm B chooses not to enter firm A's market. In this case, the two firms are engaged in tacitly-achieved behavior that yields a non-competitive equilibrium in which prices are higher than those that would prevail absent that equilibrium. In words, tacit collusion is sustained by the following strategy: "I will refrain from competing with you as long as you refrain from competing with me. But if you ever compete with me, I will compete with you in the future, and the collusion is permanently ended."

36. The economics literature has identified those market characteristics that make tacit collusion more likely. The key factors include: (1) a small number of firms; (2) repeated interaction among firms over time; (3) interaction among firms in multiple geographic or product markets (so-called "multi-market" contact); (4) barriers to entry arising, for example, from

credible threats of punishment to entrants (as discussed in the hypothetical example above); (5) distinct geographic areas; and, (6) price transparency through posted prices or publicly available price information.²⁷ Many, if not all, of these factors are present in local wholesale access markets.

37. The economics literature also includes empirical analysis that highlights supra-competitive pricing resulting from tacit collusion. For example, Fournier and Zeuhlke examine airline pricing and find that when carriers are paired through multi-market contact, prices are 9 to 12 percent higher than would be expected otherwise.²⁸ Busse examines cell phone pricing in the duopoly era and finds that prices in markets where the firms had multiple market contact prices were 7 to 10 percent higher than otherwise expected.²⁹ Other industries in which economists have found that firms tacitly collude include banking and bidding in FCC spectrum auctions.³⁰

38. The likelihood and sustainability of tacit collusion can be gauged by applying a profits test, which compares profits under tacit collusion to those under competitive behavior. This comparison depends on the values of the following variables: (1) the firms' profits under tacit collusion; (2) the firms' profits under competition; (3) the size and duration of the gain from "cheating and competing" in violation of collusion; (4) the number of firms; and, (5) the discount

²⁷ Fudenberg and Tirole (1994), "Game Theory," Cambridge, MA: MIT Press. The classic reference on multi-market contact is Bernheim and Whinston (1990), "Multimarket Contact and Collusive Behavior," 21 RAND JOURNAL OF ECONOMICS 1-26.

²⁸ Fournier and Zuehlke (2004), "Price Effects of Reciprocal Multi-Market Contacts Among Airline Carriers," Department of Economics Florida State University Working Paper. They analyze situations in which one carrier has an advantage in one market, a "city pair" for which one of the cities is a hub for that carrier, but has a small presence in a second city-pair market. Symmetrically, the second carrier has a hub in the smaller market of the first carrier, but has a smaller presence in the first carrier's hub.

²⁹ Busse (2000), "Multimarket Contact and Price Coordination in the Cellular Telephone Industry," 9 JOURNAL OF ECONOMIC AND MANAGEMENT STRATEGY 287-320.

³⁰ Heggstad and Rhoades (1978), "Multi-market Interdependence and Local Market Competition in Banking," 60 REVIEW OF ECONOMICS AND STATISTICS 523-532. Crampton and Schwartz (2002) "Collusive Bidding in FCC Spectrum Auctions," *Contributions to Economic Analysis and Policy*, Vol. 1, No. 1.

factor (the cost of capital) that is used to discount the firms' future earnings.³¹ Tacit collusion is equilibrium behavior among firms when (a) their discounted present value of earnings from collusion is higher than the sum of (b) their "one-shot" profits from cheating and competing plus (c) their discounted present value of earnings under competition.

39. With respect to SBC and Verizon, I now quantify the components (a), (b), and (c) for the wholesale access market, which competes with an ILEC's special access products. For this calculation, I assume that the market's size remains unchanged and that cash flows from operations are an appropriate measure of earnings. As reported in the FCC's Automated Reporting Management Information System ("ARMIS"), SBC has revenues of about \$4.5 billion from special access and an operating margin of about 64 percent. Verizon has revenues of about \$3.7 billion and an operating margin of about 36 percent.³² For simplicity of calculation, I assume that each ILEC has a cost of capital of 8.33 percent, or approximately 1/12.³³ In another proceeding before the FCC, SBC has claimed that competitors in the wholesale market for special access have won more than 40 percent share within SBC's territory and provide over a third of the wholesale market for DS1 and DS3 services.³⁴ Evidence indicates that the prices at which AT&T and MCI sell these circuits are half or less than half of the special access rates.³⁵

³¹ For a standard treatment of the discount factor, see any Industrial Organization text book, such as Jean Tirole (1988) "The Theory of Industrial Organization," Cambridge, MA: MIT Press.

³² See Federal Communications Commission, FCC Report 43-01: The ARMIS Annual Summary Report, <http://svartifoss2.fcc.gov/eafs/paper/43-01/PaperReport01.cfm> (Apr. 1, 2005), at Table 1 – Cost and Revenue (electronic ARMIS filing system data retrieval module main menu).

³³ The implications of my calculations are not sensitive to this assumption.

³⁴ SBC Communications, Inc., *Special Access Competition and Pricing*, at 3, presentation attached to Ex Parte Letter from Christopher M. Heimann, General Attorney, SBC Telecommunications, Inc., to Marlene H. Dortch, Secretary, Federal Communications Commission, re: Notice of Ex Parte Presentation, *AT&T Corp. Petition for Rulemaking to Reform Regulation of Incumbent Local Exchange Carrier Rates for Interstate Special Access Services* (F.C.C. Dec. 3, 2004).

³⁵ This is based on my study of winning bids and offer prices for wholesale private line local loops and interoffice transport, which I have discussed before the Commission and the U.S. Department of Justice as part of these agencies' investigations into the proposed mergers of SBC/AT&T and Verizon/MCI. Summarized results of my

40. With these numbers, we can quantify component (a), the discounted net present value of the stream of earnings from collusion. By tacitly colluding, the ILEC can raise special access revenues by (at least) five percent, either by raising prices or by converting circuits otherwise sold in their region by AT&T and MCI to special access. Note that this will raise SBC's revenues by approximately \$225 million per year (\$4.5 billion times 0.05) and Verizon's by approximately \$185 million per year (\$3.7 billion times 0.05). If all of the additional revenue is from exiting circuits, there will be little or no increase in operating costs. On the other hand, if I assume that operating margins remain the same (to obtain a lower bound), SBC's additional profits are \$144 million (\$225 million times 0.64) and Verizon's are \$67 million (\$185 million times 0.36). With a cost of capital of 8.33 percent, the present value of profits (as a lower) is approximately \$1.73 billion for SBC (\$144 million/0.0833) and \$800 million for Verizon (\$67 million/0.0833).

41. To quantify component (b), the "one-shot" profits from cheating and competing, I observe that AT&T's operating margin is about 22 percent and that MCI's is about 11 percent.³⁶ I assume for the purpose of my calculations that the companies' overall margins represent their wholesale margins. As MCI has the larger market share in the wholesale market, I assume that if one firm does not compete then the other firm could capture both firms' share making the higher margin of 22 percent. Thus, if MCI were to compete in SBC's territory after AT&T withdrew

studies are presented in several publicly available presentations and declarations. See Declaration of Simon Wilkie, *SBC Communications Inc. and AT&T Corp. Applications for Approval of Transfer of Control*, WC Dkt No. 05-65 (F.C.C. Apr. 26, 2005); Declaration of Simon Wilkie, *Verizon Communications Inc. and MCI, Inc. Applications for Approval of Transfer of Control*, WC Dkt No. 05-75 (F.C.C. May 6, 2005); Professor Simon J. Wilkie, California Institute of Technology, "SBC/AT&T: Preliminary Analysis of Competitive Effects," (D.O.J. May 9, 2005), at 21 (presentation before staff of the Antitrust Division of the U.S. Department of Justice); Professor Simon J. Wilkie, California Institute of Technology, "Proposed Mergers of SBC/AT&T and VZ/MCI: Preliminary Analysis of Competitive Effects," WC Dkt Nos. 05-65 and 05-75 (F.C.C. June 14, 2005), at 20 (ex parte presentation before the Federal Communications Commission staff).

³⁶ See John C. Hodulik et al., UBS Investment Research, *Wireline Postgame Analysis 10.0* (Mar. 17, 2005), at Table 2.

from the market, its revenues would be, say, 10 percent of \$4.5 billion, or \$450 million, with a margin of 22 percent, which yields a one-time gain of \$99 million. Similarly, if AT&T were to "cheat and compete" after MCI withdraws from wholesale in Verizon territory, its one-shot gain would be \$82 million.

42. Component (c) of the test for equilibrium is the discounted present value of the stream of earnings under competition. To quantify this component based on the current market size, I assume that MCI's wholesale sales are 6 percent of the ILEC's special access revenues and that AT&T's share is 4 percent. Given this, the net present value of the earnings from competing in the other firm's territory is revenue of \$148 million per year for AT&T in Verizon's territory, profits of \$33 million per year (\$148 millions times 0.22), and a present value of \$391 million (\$33 million/0.0833). Similarly for Verizon, its wholesale revenue stream from the SBC territory is 6 percent of 4.5 billion or \$270 million, profits of \$30 million per year (\$270 millions times 0.11), and a present value of \$357 million (\$30 million/0.0833).³⁷

43. Implementing the profits test for SBC, \$1.73 billion is greater than \$457 million (\$99 million + (0.923 times \$391 million)). Similarly, for Verizon, \$800 million is greater than \$408 million (\$81 million + (0.923 times \$357 million)). Therefore, the strategy of tacit collusion in the wholesale market is an equilibrium outcome when flipping special access lines is an option for SBC and Verizon. I conclude, therefore, that tacit collusion by SBC and Verizon in wholesale market access is likely and sustainable. Additionally, if AT&T and MCI are allowed to flip special access lines (and based on the estimated impact in Qwest territory), SBC and Verizon will have another tool, the threat to flip, that could possibly affect hundreds of millions of dollars in revenues. This provides the applicants with another tool to enforce mutual

³⁷ These numbers have to be discounted one period out, however, as they would begin after the one-shot gains from cheating and competing.

forbearance from competition. Such mutual forbearance will yield supra-competitive prices in these markets.

44. Concerns regarding tacit collusion between SBC and Verizon are not merely hypothetical. Indeed, the likelihood of tacit collusion is enhanced by Verizon and SBC's prior behavior. For example, the FCC imposed a condition on the SBC/Ameritech merger that required SBC to invest in competitive facilities in markets outside its territory.³⁸ SBC had invested a substantial amount in its "National-Local Strategy" but later retreated from its investment.³⁹ Thus, SBC has shown that it is willing to forego large revenues rather than compete with another RBOC in that RBOC's core market.

45. Similarly, SBC and Verizon divide the DSL and residential voice markets in Los Angeles based on historical RBOC territories. Both firms operate in Los Angeles and both firms offer almost identical DSL service. However, there has been as much as a \$10 discrepancy between the monthly price charged by Verizon and the price charged by SBC.⁴⁰ One of the fundamental tenets of economic competition is the "law of one price," which holds that identical products sold in the same market should have the same price because price disparities would disappear through arbitrage. Here the law of one price fails, and the reason is straightforward: SBC is forgoing arbitrage profits because it will not sell DSL to customers in Verizon's territory, and similarly Verizon will not sell to customers in SBC's territory. Thus, the two firms have

³⁸ Memorandum Opinion and Order, Applications of Ameritech Corp. and SBC Communications, Inc. for Consent to Transfer Control Corporations Holding Commission Licenses and Lines Pursuant to Sections 214 and 310(d) of the Communications Act and Parts 5, 22, 24, 25, 63, 90, 95 and 101 of the Commission's Rules, Docket No. 98-141 (FCC Oct. 8, 1999), at ¶ 399

³⁹ John Van, "Expansion Plans Get Hung Up; Ameritech Buyer is Cutting Costs," *Chicago Tribune* (Mar. 2, 2001), at N1.

⁴⁰ See generally company websites of Verizon Communications, Inc. and SBC Communications, Inc.

tacitly divided the market. In addition, SBC will not provide bundled voice service for any phone number in Verizon's territory.

46. Finally, it is instructive to look at the dearth of competition between Verizon and SBC in the business market in Los Angeles. There, CLECs are present in about 20,000 locations: 13,111 in SBC territory and 7,369 in Verizon territory.⁴¹ Of these 20,480 locations, despite a massive cost advantage from installed network bases, Verizon accounts for only 146 competitive appearances in SBC territory, while SBC accounts for a mere 113 appearances in Verizon territory. The strategic behavior of SBC and Verizon in Los Angeles is evidence that they have tacitly cooperated in the past, which further facilitates their ability to do so in the future.

ii. *SBC and Verizon Have an Effective Tool to Punish Pro-competitive Actions*

47. As I concluded above, the ability to flip special access lines enhances the likelihood and sustainability of tacit collusion between SBC and Verizon, which in turn results in supra-competitive prices. On the other hand, the ability to flip will deter pro-competitive behavior by rivals because the threat of flipping provides post-merger SBC and Verizon, acting through AT&T and MCI respectively, an effective tool to punish pro-competitive actions taken by Qwest or other carriers.

48. **[**BEGIN CONFIDENTIAL**]**

⁴¹ The source of data is GeoResults, Inc.

[END CONFIDENTIAL**]** This, in turn, will deter Qwest

from acting pro-competitively. Because the ability to flip facilitates tacit collusion between SBC and Verizon and provides those firms with a credible punishment strategy to deter pro-competitive behavior of rivals, I conclude that the ability to flip is likely to lead to a diminution of competition in the long-distance and large-enterprise markets.. Conversely, the ability to flip, as I noted before, may not lead to lower prices because it will tend to affect only inframarginal suppliers, such as SBC and Verizon.

49. The ability to flip local access lines also creates, post merger, barriers to entry into other telecommunications markets. If Qwest, Sprint, BellSouth, or some other such carrier were to undertake additional competitive entry into other telecommunications services in SBC's or Verizon's regions, the ability to flip local access lines gives the latter firms a credible threat to punish such entry. In this respect, post-merger SBC and Verizon are uniquely situated because: (1) they currently purchase the bulk of special access circuits, which implies that no other carriers have a commensurate counter-threat against them; and, (2) other competitors, such as XO and Broadwing, do not have local territories to protect against entry or, in the case of Bell South and Qwest, do not qualify for circuits to flip out of region because they have not deployed local switching.

B. Circuit Flipping May Reduce Incentives for Promised Facilities-Based Investment

50. SBC, AT&T, Verizon, and MCI together claim that a major putative benefit of their proposed mergers is that they will have greater incentive and ability to invest in facilities outside of the home regions of SBC and Verizon. The veracity of this claim depends on the hypothesis that SBC and Verizon will change their behavior and break with the current

equilibrium of mutual forbearance from competition, which was discussed in greater detail above. However, SBC and Verizon have recently claimed – and continue to claim – that the availability of UNEs undercuts the incentive of competitors to invest. Thus, there is a direct contradiction between the merger claims and their claims in other proceedings.

51. Verizon and SBC have repeatedly stressed before the FCC the likelihood that widespread use of unbundling will diminish carriers' incentives to improve and expand network facilities. For instance, in 2002, Verizon petitioned the Commission for relief from certain of the "competitive checklist" conditions established by § 271 of the Telecommunications Act of 1996 once those items – all having to do with access and interconnection to local loop transmission, transport, switching, databases, and signaling – no longer required unbundling.⁴² Arguing at the time that "[u]nbundling creates profound disincentives for investment by ILECs, CLECs, and inter-modal competitors alike," Verizon claimed that, "by requiring ILECs to share the potential rewards but not the risks of investment, unbundling deters ILECs from innovating and investing."⁴³ Unbundling, moreover, "undermines past investment by CLECs and constrains future investments by all intra- and inter-modal platform providers, since it invites virtually risk-free entry at regulatorily-determined prices."⁴⁴ It was thus not surprising, noted Verizon, "that there is almost universal recognition . . . that unbundling diminishes facilities-based competition and the deployment of innovative services and technologies."⁴⁵

⁴² See Petition for Forbearance of Verizon, *Petition for Forbearance of the Verizon Telephone Companies Pursuant to 47 U.S.C. § 160(c)*, CC Dkt No. 01-338 (F.C.C. July 29, 2002) (hereinafter "Verizon Petition for Forbearance"). See also 47 U.S.C. § 271(c)(2)(B).

⁴³ Verizon Petition for Forbearance, at 5-6.

⁴⁴ Verizon Petition for Forbearance, at 6.

⁴⁵ Reply Comments of Verizon, *Petition for Forbearance of the Verizon Telephone Companies Pursuant to 47 U.S.C. § 160(c)*, CC Dkt No. 01-338 (F.C.C. Sept. 18, 2002), at 2.

52. SBC filed comments supporting Verizon's petition for forbearance from the Commission's unbundling requirements and asked for similar treatment.⁴⁶ In doing so, SBC echoed statements made both by Verizon and federal courts regarding the costs of pervasive unbundling. For example, SBC repeated the assertion of the U.S. Court of Appeals for the Washington, D.C. Circuit that "[e]ach unbundling of an element imposes costs of its own, spreading the disincentive to invest in innovation and creating complex issues of managing shared facilities."⁴⁷ According to SBC, "[c]ontinued mandatory provision of an element once it becomes competitively available . . . stifles the incentives for competitors to invest in facilities and suppresses ILEC investment in their own networks" and thus "retards the central de-regulatory objective of the Act to promote facilities-based competition."⁴⁸ Elsewhere, SBC has again explained that "[c]ompetitive market conditions require all carriers – CLECs and ILECs alike – to make judgments regarding whether and the extent to which to invest in particular facilities" and has argued that unbundling "necessarily distorts those incentives" for all.⁴⁹

53. More recently, in December of 2003, Verizon again contended that TELRIC-based UNE rates "send distorted economic signals to CLECs and to the industry at large" and that this "has contributed to a massive decline in telecommunications industry investment by *all* providers and has devalued existing facilities investment."⁵⁰ Not only do CLECs "have little incentive to invest in their own facilities" as a result of UNEs, according to Verizon, but some

⁴⁶ Comments of SBC Communications, Inc., *Review of the Section 251 Unbundling Obligations of Incumbent Local Exchange Carriers*, CC Dkt No. 01-338 (F.C.C. Sept. 3, 2002) (hereinafter "2002 Comments of SBC").

⁴⁷ 2002 Comments of SBC, at 4 (quoting *United States Telecom Association et al. v. Federal Communications Commission*, 290 F.3d 415, 427 (D.C. Cir. May 24, 2002)).

⁴⁸ 2002 Comments of SBC, at 4.

⁴⁹ Petition for Forbearance of SBC Communications Inc., *SBC Communications Inc.'s Petition for Forbearance Under 47 U.S.C. § 160(c)*, WC Dkt No. ____ (F.C.C. Nov. 6, 2003), at 6-7 (docket number omitted in original).

CLECs "are even abandoning their own facilities in favor of UNE-P."⁵¹ Observing again that TELRIC rates also deter investment by ILECs, Verizon thus warned the Commission that the availability of UNEs at such rates has contributed to "an overall decline in facilities investment in the telecommunications industry."⁵² According to Verizon, this decline has rippled outward to the economy as a whole, causing an "annual decline in economic output and national income" and threatening harm to both competition and customers.⁵³

54. Indeed, the decision to "build or buy" is based on the relative costs. To the extent that the firms can flip circuits out of region, that lowers the costs of buying rather than building. It therefore reduces the incentive to invest. The size of this effect is of course the point of any impairment test. If the carrier is impaired, then it would not have been economic to invest by definition. Therefore, if the impairment test is correctly applied, there is no lost investment caused by requiring unbundling. However, any such test in the real world will be imperfect, and to the extent investment would have been economic, lowering the prices of inputs through unbundling will raise the opportunity cost of investing in new facilities, thereby diminishing investment.

55. To date, ATT and MCI have invested extensively in local loop and transport facilities, spending billions of dollars. Presumably, as profit-maximizing firms, the extent of their investment is wherever the "build" versus the "buy" alternative has a positive net present value given their cost of capital. Therefore the credibility of the claim that, post merger the Applicants will invest *further* relies on the hypothesis that, because of a lower post merger cost

⁵⁰ Comments of the Verizon Telephone Companies, *Review of the Commission's Rules Regarding the Pricing of Unbundled Network Elements and the Resale of Service by Incumbent Local Exchange Carriers*, WC Dkt No. 03-173 (F.C.C. Dec. 16, 2003), at i (hereinafter "2003 Comments of Verizon").

⁵¹ 2003 Comments of Verizon, at i-ii.

⁵² 2003 Comments of Verizon, at ii.

of capital, certain new investments would now have a positive return versus the alternative of purchasing inputs. However, the ability to flip these circuits then lowers the cost of purchasing these very inputs and thus directly works against the incentive to invest, undermining the putative benefit of the merger.

C. Circuit Flipping Reduces the Incentives to Build Out an IP-based Network

56. One of the claimed putative benefits of the Verizon/MCI and SBC/AT&T mergers is that it will give the combined firms a greater ability to move to IP-based networks and to offer innovative services. I have challenged the credibility of this claim elsewhere.⁵⁴ However, even if one accepts the applicants' claim that the mergers will enhance their ability to migrate to an all-IP network, the ability to flip special access circuits to UNE rates by adding legacy voice products (using the extensive AT&T and MCI inventories of legacy switches and thereby cutting those carriers' circuit procurement costs by hundreds of millions of dollars per year) undercuts the merging parties' incentive to invest in new IP-based technology. Indeed, those carriers that have developed and invested in an IP-based network, such as Qwest, will be the most competitively disadvantaged as a result of such circuit flipping.

V. CONCLUSIONS

57. The issues raised by this petition are indicative of the complexities raised by the proposed mergers of SBC/ATT and Verizon/MCI. Many of the Commission's previous

⁵³ 2003 Comments of Verizon, at ii-iii.

⁵⁴ See Declaration of Simon Wilkie, *SBC Communications Inc. and AT&T Corp. Applications for Approval of Transfer of Control*, WC Dkt No. 05-65 (F.C.C. Apr. 26, 2005); Declaration of Simon Wilkie, *Verizon*

decisions were based on hypotheses about market structure that will be rendered false by these mergers. In my economic analysis of the competitive implications of circuit flipping by post-merger SBC and Verizon, I conclude that such actions (1) will lower the costs of inframarginal suppliers which may have little or no effect on retail prices; (2) may increase the ability of SBC and Verizon to sustain and enhance tacit collusion between one another; (3) may discourage competitive entry into regions served by SBC and Verizon; and (4) may diminish incentives for facilities-based investment in telecommunications services both by the Applicants and certain competitors such as Qwest nationwide.

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10/3/05

October 3, 2005



B

A Tough Nut to Crack III: Consolidation Bypasses Inexorable Share Shifts

*Results from the 2005 Bernstein
Enterprise Telecom Decision-Maker Study*

Though the Bells have made slow but steady progress in winning share of the large enterprise market, the hegemony of AT&T and MCI is intact — and will be reinforced following the SBC-AT&T and Verizon-MCI mergers

The large enterprise market is expected to account for more than one-half of all telecom industry growth through 2010, propelled by renewed growth in wireline data and adoption of next-generation wireless data services

Wholesale services should shrink at a 7% annual rate, caused in roughly equal parts by consolidation, declines in UNE-P, and regulatory restructuring of intercarrier compensation schemes

Structural improvements from consolidation should lead to longer-term value accretion for SBC and Verizon, as synergies from their respective mergers with AT&T and MCI materialize

Portfolio Manager's Summary

In early 2005, the battle for the enterprise customer took a turn toward consolidation and away from the ground war that had been brewing among telecom providers over the prior four years. The Bells took the M&A route to overcome the high barriers that hindered them from entering organically, and to take advantage of the segment's significantly above-average growth outlook.

According to our projections, the enterprise market, though representing only about one-quarter of total U.S. telecommunications services expenditures in 2005, will contribute more than one-half of all industry growth over the coming half decade. This growth is expected to be driven by high customer reliance on wireline data services and the expected acceleration in the adoption of wireless data applications.

As part of our ongoing analysis of the enterprise market, we engaged 27 telecom decision-makers, drawn largely from the *Fortune* 500, in a series of hour-long interviews, to assess attitudes about their telecom carriers, shifting technology needs and outsourcing. Much of what we heard in this year's study was consistent with similar surveys we conducted in 2002 and 2003, but we were surprised by a few — but key — data points. Notably, recent moves to acquire AT&T and MCI notwithstanding, the Bells have gained a significant amount of credibility and traction with enterprise buyers over the past two years. They are now seen as capable of offering a bundle of services competitive with, if not fully as robust as, those of the incumbents AT&T, MCI and Sprint.

Technologically, this year's participants consider the migration to VoIP as inevitable. Nearly one-half are already either deploying the technology in some parts of their enterprise, or are actively testing it for such deployment. Similarly, nearly every participant sees the shift to IP-VPN as imminent over the next five years, despite a generally heavy reliance on legacy wireline data protocols. However, most anticipate adoption of the technology in parallel with existing data networks, not as replacements.

On the product side, we found a significantly greater commitment among this year's interviewees to wireless services. There is also an eagerness for the carriers to begin to offer wireless data services with compelling value propositions for the enterprise buyer.

As a result of consolidation, an improved pricing outlook and growing demand for enterprise wireless services, we believe SBC and Verizon are increasingly well positioned to benefit from accelerating growth in the enterprise services market. Sprint, while also likely to benefit from both price stabilization and the market's increasing reliance on wireless services is in a more difficult position — though not necessarily a losing one — as a result of the Bells' purchased entry into the market. We see both Qwest and Bell-South as increasingly disadvantaged by industry consolidation.

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